THE END OF SOCIALISM BUT NOT OF SOCIAL WELFARE

Allan H. Meltzer argues that although socialism has collapsed, the burdens of social welfare threaten their long-term viability in contemporary democracies

Socialism—public ownership of all (or most) productive assets—failed whenever (and wherever) it was tried. Only two avowed socialist states remain—Cuba and North Korea. Cuba is dragging itself slowly towards some private ownership. Literally no one admires North Korea.

For reasons that Friedrich Hayek and other classical liberals understood well, most socialist states were authoritarian and non-democratic. India and Britain are obvious exceptions. Both tried so-called democratic socialism. Both eventually increased free-market arrangements. Growth rose and poverty declined markedly.

Only capitalism achieves better living standards and personal freedom. Freedom depends on ownership of physical and human capital because capital permits people to become their own boss. But freedom and capitalist development require the rule of law. Rule of law mandates that all citizens are equal before the law, and to the maximum extent possible, all are treated the same.

Hayek claimed that the rule of law contributed greatly to the success of British and US capitalism. Socialist countries rarely observe the rule of law. They work to apply someone else's idea of a utopian society. What they believe is good and right replaces the rule of law with decrees that allegedly achieve conformity to the socialist ideal.

In contrast, capitalism adapts to many different cultures. Capitalism in Japan differs from capitalism in Western Europe, as these differ from the free-market capitalism in the United States or the state capitalism in China. In free societies, people choose the rules under which they live. In socialist societies, rulers impose their utopian vision.

The post-War years began with a widely shared belief that most countries would choose socialism. Even Joseph Schumpeter drew that conclusion. The founders of the Mont Pelerin Society dissented. They were a small minority, but they understood that freedom was valuable to people in a way that rigid socialist orthodoxies never could duplicate. And they understood that free men and women could achieve sustained growth.

The attraction socialism once had weakened as the Soviet Union failed to achieve either growth or freedom. With authoritarian China and socialist India expanding private ownership and adopting liberalising measures, all but a few small countries have abandoned socialist orthodoxy.

This defeat or rejection of socialism should not be misunderstood. One of the main appeals of socialism was its advocacy of an egalitarian distribution of wealth, income and influence. Hostility towards capitalism always highlights

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inequality and recessions or business cycles. But as many could see, and a few like Milovan Djilas wrote, socialism did not eliminate income differences. Rather, it transferred power, influence and high income to a 'new class.' And to the extent that measures of income inequality showed less dispersion, the price paid in income levels and freedom was high. People in East Germany, North Korea, and China compared their fate to residents of West Germany, South Korea, and the Chinese diaspora, including Hong Kong, Singapore, and Taiwan. The famous Berlin Wall restricted emigration but not immigration. No one chose to move to East Germany.

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Political pressure for redistribution remained. The social democratic welfare state offered grants and subsidies that redistributed wealth and income and increased the reported unemployment rate. After climbing to within 80% of the per capita income in the United States, on average, Germany, France and Italy began to pay some costs of the welfare state. From 1980 to 2005, these countries averaged 1% slower growth than the United States. After 25 years, a gap of nearly 25% growth rate was explained away by lower employment rates.

No country, democratic or authoritarian, will accept the market's decision about the distribution of income. All countries modify the market outcome, most of them by taxing and transferring from high incomes to low incomes. The politics of the social democratic welfare states can only reduce transfers and costly redistribution in a crisis.

Stimulating the US economy

The failed policies for recovery in the European Union and the United States reflect the dominant influence of social welfare redistribution over recoveries. In the United States, President Barack Obama's principal economic adviser, Lawrence Summers, said in 2009 that policy actions should be 'timely, targeted, and temporary.' The so-called stimulus policies that the United States adopted gave temporary relief to public employees, teachers and police and subsidised investment in solar power, batteries, electric automobiles, and insulation.

The results show that the subsidised autos did not sell well; the main subsidised producers of solar panels failed; and error, corruption, and political favouritism reduced effectiveness. A detailed study of the nearly $900 billion in stimulus offers some examples.*

In Illinois, inspectors failed to detect a gas leak from a newly installed furnace that could have seriously injured the home's residents. Contractors billed for labour that wasn't done and materials that weren't installed. Fourteen out of 15 homes visited failed inspection. In New Jersey, auditors identified 12 households that were approved for free repairs despite earning an income of more than $100,000. Agencies bought $1,500 GPS systems and underpaid their workers. The state's system of eligible applicants contained the social security numbers of 168 dead people. A nonprofit in Waukesha, Wisconsin, got stimulus money despite having spent weatherisation funds (federal funds to low-income families to make their homes more energy efficient and reduce energy bills by using the latest technology and testing methods) on Christmas decorations, gift cards for employees, and a parking ticket. West Virginia had to take over one agency's weatherisation program after finding 'shoddy work, falsified reports, credit card abuses, and missing inventory.' An inspection of a Houston nonprofit found that work was so sloppy that contractors had to go back and repair 33 of the 53 homes reviewed. Investigators in California found untrained workers. And Delaware suspended its entire weatherisation program for nearly a year after a scathing report documented problems with nearly every aspect

* Michael Grabell, *Money Well Spent?* (New York: Public Affairs, 2012), 11.

of the program, leading the Department of Energy to freeze the program's funds.

The most successful fiscal policies in post-War United States were the Kennedy-Johnson and Reagan tax cuts for households and businesses. These programs marshalled profit incentives to guide investment choices. The Obama program, like most political decisions, was less concerned about gaining economic efficiency and more about choosing who paid and who received. One of the major flaws in what are called Keynesian policies is that the designers act on the premise that what matters is the amount spent, not the way it is spent. Keynes did not make that mistake.

European Union

In the European Union and the European Central Bank (ECB), the daily discussion is about getting Germany and a few other fiscally responsible countries to bail out welfare state spending in the debtor countries. I am appalled by the pressure put on Germany by bankers and their friends to subsidise welfare states in the European Union. The *Financial Times* is particularly outrageous. Prime Minister Margaret Thatcher said that welfare states would shrink when they ran out of other people's money. We are there. But instead of adjusting down, the bankrupt governments are proposing institutional changes that, if adopted, would sustain profligate redistributive policies.

High unemployment and prolonged recession or slow recovery are serious problems that require rational policy action. Most welfare states are so large that rational policies are politically unpopular, perhaps even unacceptable.

We are reaching the point at which the welfare state's promises of redistribution will shrink. Or we will lose democratic capitalism. Voters will not end the welfare state and redistribution, but promises in many countries greatly exceed resources available for payment. Sweden, once the envied model of a welfare state, has made a start by reducing some transfers.

The crisis is here and now in the European Union and the United States. Even those who favour programs and policies that transfer responsibility and decisions from the market to the bureaucracy must see how difficult it is for government to develop meaningful reforms. No one believes that the unfunded promises that are driving future US debt and deficits will be paid if nothing is done. On the contrary, everyone who seriously discusses the future welfare state debt and deficits uses the word 'unsustainable.'

Many in the European Union point their finger at the 'rich' Germans requesting, even demanding, transfers of one kind or another. The German government responds by saying, 'We have given ample support. You, the debtors, must reduce domestic transfers and become more competitive by reducing real wages.' Another continuing stalemate. The widespread reluctance to recognise the problems of welfare states prevents a solution.

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I find it appalling that almost all the discussion of the European crisis is about the debt incurred by Greece, Italy, Spain and Portugal. Almost every day, the *Financial Times* publishes articles that urge Germany to accept more inflation to bail out the banks and other lenders. Do the writers and the editors think that the problem is entirely monetary and can be solved by lowering interest rates and printing money?

Germany recognises that the problem is real, not just monetary or debt related. Costs of production are 25% to 30% greater in Greece, Italy, Spain and Portugal than in Germany. Without lowering costs in these countries, growth cannot resume or even continue unless some stimulus gives temporary relief. Germany wants real reform of labour, commodity markets, and government policy.

There are two ways to reduce real wages in a fixed exchange rate system. The so-called austerity favoured by Germany would both reform the economies and force reductions in real wages. After three years of economic decline, getting an additional 25% to 30%

reduction in real wages in this way seems to be politically impossible. Voters will not retain in office a government that cuts real wages; political opportunists oppose 'austerity.'

Devaluation is an alternative way to reduce real wages. The ECB should permit the indebted southern European countries to form a temporary weak euro. The strong euro countries would adopt the fiscal restrictions to which their own representatives agree. The weak euro countries would float down against the strong euro. Once devaluation reduces real wages, countries in the weak euro would rejoin the strong euro by agreeing to the fiscal rules.

The United States has also failed to reduce or moderate its future budget deficits. Again, the problem is a failure of the political system to reduce spending or agree on a comprehensive program to balance the budget.

Devaluation would work quickly. It is not without cost. Two are of particular importance. First, the devaluing countries must limit bank runs or currency runs by enforcing temporary exchange controls. And they must avoid subsequent inflation. Second, German and French banks would suffer losses on their holdings of foreign bonds. The French and German governments should require their banks to raise half of their capital shortfall. Government would supply the other half at concessional rates. If a bank failed to raise its half in the market, it would be declared insolvent and taken over by regulators. That gives the bank an incentive to raise its share of the capital infusion.

Social welfare state governments in Europe cannot agree on a solution to their major problem. They resist imposing the requisite costs on their voters. Often they fail to carry out the pledges they make. They cannot agree to change who pays and who receives, the main point of the welfare state. The most common demand is for Germany to be more generous. The German public refuses to transfer any more money to foreigners.

The euro problems are common problems for fixed exchange rate systems. Governments must limit their budget deficits, the size of outstanding debt, and keep their terms of trade close to their exchange rate. Like many other fixed exchange rate systems, the euro failed to meet these requirements. And it has not been able to agree on a program to restore stability and growth. These failures will restrict the welfare state and egalitarianism. It will not end pressures for redistribution.

The United States

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The problem is not new. From 1930 to 2012, the federal government approved a balanced budget or a budget with a surplus of revenues over spending in successive years only twice. President Dwight D. Eisenhower was a fiscal conservative. He favoured balanced budgets in all years without a recession, and he gave many speeches about fiscally responsible spending. President Bill Clinton raised marginal tax rates early in his first term. But he also slowed spending growth enough to run budget surpluses for several years. Budget surpluses raise expectations that future tax rates will reduce and investment and growth will increase.

In contrast, from George Washington's presidency in 1789 to the Great Depression in 1930, the federal budget had a surplus in two-thirds of the non-war years. Wartime deficits did not continue after wars. Peacetime governments reduced debt. As late as the 1920s, Secretary Andrew Mellon was able to reduce tax rates and wartime debt by running budget surpluses.

The Great Depression was followed by several wars that led to increased government spending. The size of government, measured by the ratio of federal government spending to GNP or GDP, rose from 3% in 1930 to about 18% in recent decades. The Obama administration increased spending to 25% of GDP. Its budgets are rejected unanimously by Congress. Unlike the early post-War budgets, which included a heavy defence component, social spending is by far the largest share of federal spending. Most of social spending is labelled 'entitlement spending,' suggesting (falsely) that it cannot be reduced without depriving recipients of something that is their due.

So-called 'entitlements' put future budgets on an unsustainable path in the United States and many other countries. For the United States, future spending on health care and retirement has a current value of more than $70 trillion. There is no combination of tax rates, expected growth, and reductions of other spending that permit the promised entitlements to be paid.

The gold standard

Why was the modest size of government in the nineteenth and early twentieth centuries maintained and accepted almost everywhere? I credit two main but related reasons: the international gold standard and the widespread belief that government, like households, should balance its budget. Persistent peacetime budget deficits raised concerns that a country would have to devalue against gold. The currency would move to the gold export point, requiring intervention. Intervention could succeed in stabilising the gold exchange rate only if the market expected fiscal discipline to improve.

I have never advocated a return to the gold standard mainly because the public prefers stable domestic prices and employment to a stable exchange rate. A second reason is that a single country that fixed its exchange rate to gold would buffer shocks for all other countries by inflating and deflating when others demanded to buy or sell gold. An effective gold standard must be universal, or at least, multilateral.

The enduring lesson from the gold standard years is that a publicly accepted monetary rule that maintains a stable domestic price level (or a low rate of inflation) also restrains budget deficits, just as fiscal restraint supports the monetary rule. Only a policy of rules can restore growth and sustain freedom. That is the policy we must aspire to.

Collapse of the welfare state

After John Maynard Keynes read Hayek's *Road to Serfdom*, he wrote to Hayek praising the book but disagreeing with its conclusion. Keynes claimed that if well-intentioned people made the decisions, the outcome would be beneficial and desirable. This is a major flaw in the organisation and operation of social democratic governments and welfare states. They presume most often that they are selfless and know better than the public about what is right.

Detailed regulation often proclaims that it is done 'in the public interest.' Most often it brings special privileges, crony capitalism, corruption and circumventions.

The great German philosopher Immanuel Kant had a better understanding of human character. He wrote: 'Out of timbers so crooked as that from which man is made, nothing entirely straight can be carved.' Christian theology at the time saw humans as morally imperfect. Some exceptions can be found in all eras, but it is a mistake to rely on goodwill and good intentions. Twentieth-century experience in authoritarian states and the democracies of Western Europe and India alike reminds us that 'power corrupts.'

Kant's judgment warns us that we should not expect benevolent government regulation. The rule of law directs government to treat all citizens as equal before the law. This is an ideal that guides regulation towards desirable outcomes. Like all good policies, it is a rule.

Detailed regulation often proclaims that it is done 'in the public interest.' Most often it brings special privileges, crony capitalism, corruption and circumventions. Powerful Soviet or Chinese officials had access to better opportunities, better food, and better health care than ordinary citizens. Democratic India became known for bribery and corruption of officials who wanted privileges.

After writing the Constitution of the United States, James Madison contributed to the

Federalist papers to promote ratification. He insisted that the Constitution limited the power of the federal government, and in *Federalist 10*, he warned about the threat posed by 'factions.' Today we have replaced factions with interest groups. As Madison warned, interest groups protect their interest at the expense of others.

Interest group politics makes it difficult to reform the welfare state or remove the pressure for egalitarian outcomes. Here are some examples. In the 1980s, it became clear that many savings and loan associations would fail. Deposit guarantees protected depositors, but failure imposed losses on taxpayers. The US Congress acted to hide the problem, but some managements understood that delay created opportunities to take risky gambles that would restore the value of equity if the investment paid off. Since equity was low or negative, the cost of additional losses would be borne by taxpayers. Some took the gamble. Taxpayers' losses reached $150 billion.

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A few years later, President Clinton appointed Jim Johnson to head the Federal National Mortgage Association (Fannie Mae or FNMA). FNMA began in 1937 as a purchaser and occasional seller of outstanding mortgages to smoothen fluctuations in mortgage rates and create a more liquid market. Later, the Federal Home Loan Bank Board (FHLBB) created a separate organisation, the Federal Home Loan Mortgage Corporation (Freddie Mac or FHLMC) to buy and sell mortgages.

Johnson had been a campaign manager in Walter Mondale's 1984 presidential campaign. He was well connected politically and wanted to make homeownership more egalitarian. He saw an opportunity to expand FNMA's operations while offering opportunity to low-income homebuyers. The political appeal of expanding homeownership was popular. To facilitate this program, the government agencies lowered down payments and later offered to buy sub-prime mortgages with no down payment for borrowers that had no credit history.

Selling sub-prime mortgages to the two government sponsored buyers, Fannie Mae and Freddie Mac, was a very profitable business. Some mortgage lenders actively worked to issue such mortgages that could be resold profitably. Major banks did the same. An international agreement required the banks to hold larger reserves behind mortgages in their portfolios. The banks circumvented the costly regulation by chartering subsidiaries that held the mortgages but evaded the requirement. Regulators did not object.

A few voices that pointed to the risk of defaults and losses were ignored or dismissed. Congressman Barney Frank was chairman of the house committee with oversight responsibility. He urged expanding the program. President George W. Bush viewed the programs as part of his 'ownership' program. He did not ask: 'What did the homebuyers own?' Many made no down payments; they 'owned' an option to gain home equity if home prices rose, but they also owned the prospect of loss if home prices fell.

Contrary to repeated forecasts that home prices would not fall throughout the country, the unthinkable happened. The social welfare experiment in expanding homeownership to minorities and low-income families failed in a wave of mortgage defaults and foreclosed houses.

In January 2009, the Obama administration inherited the housing and financial failures. Its program design called for a massive increase in government spending and temporary tax reductions. Professor Summers, head of the new president's economic staff, said that the program should be targeted and temporary. Bad advice! Decades of economic research showed that temporary tax reduction and spending increases get very little response.

Congress developed the program details. Their interest as always was in distributing financial support to their political supporters, so the supposed economic stimulus became an example of welfare state redistribution. For example, money was spent to help states avoid laying off teachers. When the funding was not renewed, layoffs resumed. So what was achieved?

A principal weakness of the program was its short-term focus. A large stock of unsold houses and projected defaults on mortgages implied that the recession would be deep and long lasting. Properly designed policy changes would have avoided targeted and temporary changes and offered permanent incentives for investment. A better policy would have been to increase incentives for investment and adopt rules for future fiscal and monetary policies.

The social welfare state empowers interest groups that demand support from their political allies. Their main concern is benefits to them and their members. They oppose efforts to reduce spending on their benefits. Fire and police unions receive such large pension and health care benefits that state and local governments are forced to reduce spending on such basic functions of government as police or fire protection. At the federal level, spending for pensions and health care force reductions in spending for defence against terrorism.

Every knowledgeable observer agrees that projected growth of federal government spending is unsustainable. Still, the federal government does not propose reductions. Any 10 solutions that reduce spending act like a tax levied on particular groups—the retired and their families, the teachers union, or some other organised group. Greece, Italy and Spain waited for the crisis to force drastic changes that could have been phased in gradually and less painfully. Must the United States repeat their error?

Similar problems threaten the survival of the European Union. As in the United States, voters agree to increase spending on redistribution for pensions, health care, and the unemployed, but few vote to pay for the benefits. Budget deficits increase until they are unsustainable and markets are unwilling to finance them.

The political system cannot agree on a program. Short-term palliatives prevent an immediate crisis, but the problems remain. Uncertainty rises, so investment falls. The debtors urge the creditor countries to pay more and to forgive debts. The creditors demand reforms that open markets, reduce the power of labour monopolies, raise retirement ages, sell state industries, and reduce transfer payments. Each of these affects a powerful interest group. And it reduces the proliferation of the welfare state.

And perhaps we can convince governments that changing incentives and adopting policy rules, not exhortation and direction, are the most effective methods for bringing lasting change.

Conclusion

Madison warned that 'factions,' now called 'interest groups,' are a threat to democratic governance. His fears are now reality. The social welfare state has become the prisoner of interest groups that demand ever-increasing benefits and resist any changes that lower their benefits.

That puts the social welfare state on an unsustainable path leading to its eventual collapse. Experience in the European Union and the United States shows these political unions are headed for a crisis. But it will not end the welfare state. Political pressure for redistribution carried out in the name of equality is always present. The most we can expect is sufficient reduction in spending to maintain democratic capitalist governance. And perhaps we can convince governments that changing incentives and adopting policy rules, not exhortation and direction, are the most effective methods for bringing lasting change.